

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Soto Analyst: Kimberly Pantoja Bill Number: SB 16X  
Related Bills: See Legislative History Telephone: 845-4786 Introduced Date: 01/24/01  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Dairy Farm Electric Generator Refundable Credit

### SUMMARY

This bill would create a refundable tax credit for the purchase and installation of generators used to produce electricity at dairy farms located in California.

### PURPOSE OF THE BILL

This bill provides that the intent of the Legislature is to establish a tax credit for dairy farms to purchase and operate on-site power generators for them to produce their own power.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 2001.

### POSITION

Pending.

#### Summary of Suggested Amendments

Technical amendments are provided to replace a credit that would be deleted by the bill and to address the order in which refundable credits are to be allowed in the Bank and Corporation Tax Law (B&CTL).

An amendment is suggested to provide appropriation language to fund the departmental costs associated with administering the proposed credit.

### ANALYSIS

#### FEDERAL/STATE LAW

Both state and federal laws allow a deduction for all ordinary and necessary expenses of a trade or business, including expenses relating to energy conservation measures. If the expense is for a repair to existing equipment that does not extend the useful life of such equipment, it is deductible in the year paid or incurred. If the expense is for a replacement, and the useful life of the equipment replaced is more than one year, or the repair extends the useful life of the equipment, the cost can be depreciated over the useful life of the equipment.

Board Position:

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_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Alan Hunter for GHG

03/30/01

Both state and federal laws provide various tax credits designed to provide tax relief for taxpayers that must incur certain expenses (e.g., renter's credit) or to influence behavior, including business practices and decisions (e.g., research credits).

Neither state nor federal laws have a credit comparable to the credit proposed by this bill.

### THIS BILL

Under the Personal Income Tax Law (PITL) and the B&CTL, this bill would create a tax credit equal to 100% of the expenses paid or incurred by a taxpayer for each portable or permanent generator that provides electric service onsite at a dairy farm located in California.

The bill specifies the credit would only be allowed for the taxable year in which the generator is first put into operation.

The bill defines "expenses" to include the purchase price of the generator and all expenses for its installation, upgrade, or expansion. "Dairy farm" would be defined, by reference to Section 32505 of the Food and Agriculture Code, to mean any place or premises upon which milk is produced for sale or other distribution and where more than two cows or six goats are in lactation.

The bill would allow a taxpayer to claim the proposed credit in addition to any deductions, including the business expense deduction or depreciation deduction, for any expenses for which the credit is allowed.

The bill specifies the proposed credit shall only be allowed with respect to a generator that the operation and maintenance of which complies with local and regional air quality standards.

This bill specifies that any credit in excess of the taxpayer's tax liability would first be credited against other amounts due, and the balance, upon appropriation by the Legislature, would be refunded to the taxpayer.

This bill would include the dairy farm electric generator refundable credit in the list of credits that can reduce regular tax below tentative minimum tax (TMT) for purposes of the alternative minimum tax (AMT) calculation.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The bill provides a credit equal to the expenses paid or incurred for a portable or permanent generator and defines expenses to include the purchase price and all expenses for installation, upgrade, or expansion. However, the language of the bill does not clearly limit the credit to these expenses. Consequently, taxpayers could argue that any expense for a generator is eligible for the credit.

The bill requires that the operation and maintenance of the generator comply with local and regional air quality standards to qualify for the credit. Taxpayers and department staff do not have independent expertise in the area of generators and thus may have difficulty determining whether the generator complies with this requirement. Requiring independent expert verification of the property and its compliance with this requirement would aid the department in administering this credit.

The bill does not specify whether the generator must be purchased "new" or whether a used generator would also qualify for the credit. Since the bill is silent on this point, any generator, whether new or used, would potentially qualify for the credit if it is able to meet the compliance standards.

The bill specifies that the generator must "provide electric service onsite." However, no standard is specified to determine whether a taxpayer has complied with this requirement. Also, the bill does not require the dairy farm to actually cease receiving power from the grid to qualify for this credit. Clarification is needed on these points to ensure that the author's intent is achieved.

The bill does not provide for the recapture of the credit if the generator is sold or is no longer used within a specified time period. Since the bill does not require actual use of the generator for a specified period, it is theoretically possible for taxpayers to resell these generators among themselves and generate multiple credits in multiple tax years.

Public utilities often offer grant programs to encourage people to install and use energy conservation measures. Generally, the amount of any grant received that assisted a taxpayer in the purchase and installation of an eligible item reduces a credit allowed for the same expense. This bill requires no such reduction of the credit.

A large number of taxpayers lease certain items of property rather than purchase them. This credit would not be available to any taxpayer that leases a "dairy farm electric generator" for use in this state where the user is not the tax owner of the generator. However, the bill does not prevent the taxpayer that purchases a dairy farm electric generator and leases it to another taxpayer in this state from claiming the credit, even if the lessee is essentially paying for the dairy farm electric generator through the lease payments.

The department has never administered a refundable tax credit under the B&CTL. Establishing a refundable tax credit program would have a significant impact on the department's programs and operations and require extensive changes to forms and systems.

This bill does not modify the hierarchy of B&CTL tax credits (Section 23036). Thus, the bill does not specify the order in which credits would be applied against tax liability. Would other, non-refundable credits be applied first to increase the likelihood that there would be excess credit to be refunded. Alternatively, this credit could be required to be applied against tax liability first to decrease the likelihood that there would be excess credit to be refunded. The existing hierarchy of tax credits under the PITL includes refundable credits (Section 17039). Amendment 3 has been provided to resolve this consideration by establishing an order that would increase the likelihood that there would be excess credit to be refunded.

This bill leaves unclear whether taxpayers that are pass-through entities (partnerships, limited liability companies, and S corporations) could claim the credit and receive the refund, or whether the entity must pass through the entire credit to the investors (partners and shareholders), or whether FTB would be required to refund the credit amount in some fashion to both the entity and the investors.

Moreover, it is unclear whether, in the case of a pass-through entity, both the entity and the investors would receive the full credit amount. For ease of implementation, this bill should specify that the entire credit amount shall be refunded to the entity that incurred the expenses for the generator.

Since the proposed credit is refundable, the credit would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540 2EZ. This would increase PIT return Forms 540, 540NR, 540X, and potentially the 540A by one page. Adding a page to these forms would result in a significant impact on FTB's operations and costs, would slow return processing, and would increase the amount of return storage space. The department would work within available space to the extent possible, however the department may be required to lease additional office and file storage space.

This bill would require regular appropriations by the Legislature to pay for the refundable portion of this credit. If sufficient funds were not appropriated to cover all of the refunds due, the department would suspend payment of the refunds until additional funds were appropriated. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

#### TECHNICAL CONSIDERATIONS

Amendment 1 would add the dairy farm electric generator refundable credit to the state statutes that specify the order in which refundable credits are allowed.

This bill would delete a solar energy credit from state law that allows credits to reduce regular tax below TMT for purposes of the AMT calculation. This credit should not be eliminated from this list as it is still being claimed by taxpayers. Amendment 2 would restore this credit.

#### **LEGISLATIVE HISTORY**

SB 38X (Oller, 2001-02 First Extraordinary Session) would create a tax credit for the purchase of a generator and related equipment for the production of emergency power. It is currently in the Senate Environmental Quality Committee.

#### **OTHER STATES' INFORMATION**

The laws of the following states were reviewed because their tax laws are similar to California's income tax laws.

*Massachusetts, Michigan, and New York* do not provide a tax credit comparable to the credit proposed in this bill. The following is a brief list of incentives provided for energy conservation by the comparison states.

*Massachusetts* has an extensive program of tax exemptions and credits designed to encourage the consumption and production of energy efficient systems and alternative energy systems. These tax benefits include the following: individuals are allowed a credit for the purchase and installation of solar or wind energy systems for their residence; and businesses are allowed a deduction for the purchase and installation of solar and wind energy systems for heating, air conditioning, or water heating purposes.

*Michigan* does not generally provide energy conservation incentives through the tax system but uses an extensive system of grant and loan incentives to encourage investment in alternative energy and energy conservation.

*New York* has programs designed to affect both the consumption and the production of energy conservation systems and alternative energy equipment. Individuals are allowed a credit equal to 25% of certain solar electric generating expenditures.

## **FISCAL IMPACT**

The department's costs to administer this bill are estimated to be \$530,000 for fiscal year 2001-02. It is estimated that this bill would require the department to incur five additional personnel years (PYs) in 2001-02 to process and administer this credit. Amendments 4 and 5 are provided to suggest language for an appropriation to fund these departmental costs.

The estimated costs are associated with the printing and processing of the additional page to each return, changes to the computer systems, increased taxpayer telephone calls and correspondence, and electronic and paper storage.

Costs have not been determined at this time for an undetermined number of PYs for fraud investigators that may be required to verify this credit.

## **ECONOMIC IMPACT**

Due to the lack of defined requirements to qualify for the credit, as discussed under implementation concerns, this bill could result in a potential revenue loss exceeding \$100 million annually.

## **ARGUMENTS/POLICY CONCERNS**

Historically, refundable credits (such as the prior state renter's credit and the federal Earned Income Credit) have had significant problems with invalid and fraudulent returns. These problems are aggravated because a refund that is later determined to be fraudulent commonly cannot be recovered.

This bill does not require the taxpayer that purchases and installs the electric generator on-site at a dairy farm to be the owner or operator of the dairy farm or to own an interest in a dairy farm. The availability of a refundable credit may provide an incentive for creation and marketing of tax shelters.

This bill specifies the taxpayer may claim the proposed credit in addition to any deduction allowed for the same expenses. Thus, this bill would allow taxpayers to claim multiple tax benefits for the same item of expense in excess of the taxpayer's actual economic investment in the property.

Credits generally are provided as a percentage of amounts paid or incurred. This bill would allow a 100% credit, which is unprecedented.

This bill does not specify a repeal date. Credits typically are enacted with a repeal date to allow the Legislature to review the effectiveness of the credit.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 16X  
As Introduced January 24, 2001

AMENDMENT 1

On page 2, line 37, after "Sections" insert:

17053.83 (relating to dairy farms),

AMENDMENT 2

On page 3, strike lines 13 through 17 inclusive, and insert:

(C) The credit allowed by former Section 17052.5 (relating to solar energy, repealed as of January 1, 1987).

(D) The credit allowed by former Section 17052.5 (relating to solar energy, repealed as of December 1, 1994).

@@@@@@@@@@@@ Leg Counsel: Renumber subsequent subparagraphs. @@@@@@@@@@@@@@

AMENDMENT 3

On page 7, strike lines 25 through 33 inclusive, and insert:

(c) Notwithstanding any other provision of this part, credits shall be allowed against the "tax" in the following order:

- (1) Credits that do not contain carryover or refundable provisions.
- (2) Credits that, when the credit exceeds the "tax," allow the excess to be carried over to offset the "tax" in succeeding taxable years, but do not contain refundable provisions. The order of credits within this paragraph shall be determined by the Franchise Tax Board.
- (3) Credits that contain both carryover and refundable provisions.
- (4) The minimum tax credit allowed by Section 23453.
- ~~(4)~~ (5) Credits for taxes withheld under Section 18662.
- (6) Credits that contain refundable provisions but do not contain carryover provisions.

AMENDMENT 4

On page 10, between lines 33 and 34 insert:

SEC. 6. (a) There is hereby appropriated from the General Fund for expenditure in the 2001-2002 fiscal year the sum of five hundred thirty thousand dollars (\$530,000) for allocation to the Franchise Tax Board in augmentation of Item 1730-001-0001 of the Budget Act of 2001.

(b) Funds allocated pursuant to subdivision (a) shall be expended by the Franchise Tax Board solely for the purposes of implementation and administration of the Dairy Farm Electric Generator Refundable Credit, pursuant to Sections 17053.83 and 23683 of the Revenue and Taxation Code, as added by this act.

SEC. 7. This act makes an appropriation for the usual current expenses of the state within the meaning of Article IV of the Constitution and shall go into immediate effect.

AMENDMENT 5

On page 10, line 34, strike "SEC. 6." and insert:

SEC. 8